# Piercing the Contractual Veil? The Social Responsibility of Contractual Networks

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## 0. Hybrid rationality

"Piercing the contractual veil" - is this how critical contract law should respond to challenges posed by new organizational arrangements between market and hierarchy? For decades economic concentration has been the prevailing trend (Chandler, 1977), however

> since the recession at the beginning of the 1980s, however, this trend has been reversed. As well as the decomposition of capital into separate corporate entities in an endeavour to replicate efficient capital markets, managers of large firms have exhibited a greater interest in disintegration, by arranging aspects of production through subcontracting, franchising, concessions, and outsourcing. Similar developments have occurred in the public sector as one aspect of the policy of privatization (Collins, 1990b:353).

The most recent species which sprung out of this process of socio-economic evolution, as a particular result of decentralization, vertical disintegration, and privatization of large enterprises, has many names. "Hybrids", "network contracts", "symbiotic contracts", "organizational communities"," strategic alliances", "many-headed hydras", and "golden handcuffs" are some of the more evocative metaphors for these strange quasi-corporate beasts that find their ecological niche in a "third area of allocation", in an intermediate area between organizations and markets. Hybrids usually come in contractual disguises: just-in-time organizations and other satellite

delivery networks, franchising systems and other distribution organizations, data processing contracts as a result of "outsourcing", credit transfer networks in banking, subcontracting systems in the construction industry, networks in energy, transportation and telecommunication, strategic alliances in collective research, large scale consortia in collaborative research pacts. Their contractual form poses a challenge to the private law of the welfare state which has developed a whole range of social regulations to tame corporate beasts. How do these hybrids react to social regulation? To evade or to innovate - that is the question. If "in reality" these hybrids are fully-fledged hierarchical organizations which are only covered by a veil of contract then "piercing the contractual veil" seems to be the appropriate future task for a critical contract law. Piercing would rediscover their economic reality disguised by contract and reintroduce the protective norms of social regulation.

What are the standards of critique? Critical contract law is commonly understood as a law that is critical of power and domination in society and takes side with consumers, workers and small business. This raises, however, the uncomfortable question of how such a critique is able to reconcile its somewhat uncritical partisan support for particular social interests with its original universal aspirations. There exists, fortunately, a different understanding of critical contract law. It goes back to the classical European tradition of *Kritizismus* which has always seen its task as the epistemological critique of dominant reason. Against the dominance of speculative metaphysics, Kant's Critique of Pure Reason rejected pure philosophical reason's claim to truth and replaced it by the interplay of *a priori* categories and empirical observation (Kant, 1781). More recently, a critique of instrumental reason (Horkheimer, 1947) and a critique of functionalist reason (Habermas, 1987) have taken up the tradition of classical *Kritizismus*. Turning to our narrow field of contract law which is concerned with the legal reconstruction of economic transactions, the more modest task of a critical contract law, I submit, is the legal critique of pure economic reason (Gorz, 1989) which is colonizing legal thought. Critical contract law the claim to legal validity of economic reason asserting instead the validity of legal policies in interplay with the episteme of law.

Looking to our hybrid arrangements between contract and organization, critical contract law would not simply accept economic reason that declares these results of economic evolution as "efficient" and, thus, legally sound. Rather, it reconstructs them autonomously under its own quasi-aprioristic schemata of legal cognition. Critical contract law critically re-examines the claims to economic efficiency from three perspectives: first, the "guiding distinction" legal/illegal, second, the perspective of legal "policies" which are the political programmes of democratic legislation translated into law, and, third, the requirements of "justice" understood as a legal balancing of different social rationalities (see Teubner, 1992: Ch.6).



I shall try to critically re-examine the economic reason of hybrids while dealing with three legal topics. I shall focus on legal problems of external liability of hybrids, on questions of contractual justice within hybrid arrangements and on issues of constitutionalizing the "quasi-corporate beast". I shall reconstruct step by step the debate among economists and lawyers which develops in a kind of dialectical movement from argument to counterargument to the next level of argument and counterargument and so on.

(1) *Consumer protection against hybrids*. In the construction industry, a main contractor is subcontracting work to a whole range of specialized firms. If problems of tortious and contractual liability emerge within this network of cooperation, is legal liability then limited by the rules of contract. Alternatively, does the law entitle the customer to "pierce the contractual veil" in such a *groupe des contrats*, as it is entitled to with corporate groups? Practically this may take different doctrinal forms, be it *action directe*, an expansion of *respondeat superior* or the vicarious liability of one actor for the whole organization.

Similar constellations are found in the banking sector. If in a chain of cashless credit transfer, one of the many intermediary banks included in the transfer chain commits an error, does the customer have a claim to contractual, tortious or "contortious" liability against the bank involved although there is no direct contractual link with the customer? Or can the customer make the first bank responsible for every error in the whole network? What if the error was "in the system" so that no individual bank can be blamed and the error can only be attributed to the inter-bank-agreement which again has no corporate but only a contractual character?

Similar problems occur in franchising systems. These concern the responsibility of the central franchisor for faults committed by a single franchisee. Moreover, it is especially difficult to deal with constellations in which a "product policy committee" consisting of all members of the franchise system, i.e. a quasi-corporate body in a contractual network, has made a collective decision which turns out to have disastrous consequences for the customers. Can the whole nexus of contacts be collectively liable?

(2) *Labour protection for semi-autonomous entrepreneurs*. In delivery and distribution networks, a core firm is surrounded by satellites that retain ownership and residual income but are integrated into a tightly knit organ-

ization via a nexus of elaborate contracts with the core firm. If things go wrong, can the semi-autonomous entrepreneur invoke his economic dependency and ask for the protection of labour law? Are there at least some protective requirements for the conclusion of such dependency contracts? Does the core firm owe a special fiduciary duty toward the dependent quasi-employees? Is there protection against unfair termination, at least to protect the sunk investments of the franchisee?

A different question is whether there is labour protection for the workers of the franchisee in relation to the franchisor as the centre of the whole franchise system. Under the contractual regime of franchising only the franchisee appears as their employer. Accordingly, they have only the protective rights governing small business and are deprived of those individual and collective rights which they would enjoy in large-scale corporations. De facto, however, a franchising system is a large-scale organization. Is there a need for a legal construct that takes this de facto situation into account?

(3) *A legal constitution for corporate governance in contractual networks*? Just-in-time delivery networks have all the structural peculiarities of a corporate group, except one. The dependency relation is not of corporate but of contractual character. They are legally autonomous enterprises under the control of a dominant enterprise. This raises the question of whether the protective rules which have gradually been developed in the law of corporate groups could also be applied to *groupe des contrats*. Does the dominant enterprise owe a special fiduciary duty to the business interests of its quasi-subsidiaries? And, could one apply the rules of co-determination in groups of companies that have been developed in German law, so that the workers of different satellite firms in contractual networks would be represented in the *Konzernbetriebsrat* and in the *Aufsichtsrat* of the core enterprise?

## 1. Economic argument § 1

### *1.1. The argument: Hybrids increase contractual flexibility*

The initial reaction of economic policy makers was to attempt to classify hybrids within the terms of the somewhat crude dichotomy of market versus hierarchy (Jarillo, 1988:31). They heralded the new "flexibilization" of rigid hierarchies as the final victory of economic reason (EIRR, 1985; cf. the discussion in Streeck, 1987:286 ff.). Contractual flexibility was the



slogan. In a period of globalization of markets, extremely rapid market changes, heightened competitive pressure and collapsing governmental regulatory regimes, centralized large-scale organizations appeared rigid, sclerotic and immobile. Decentralization, vertical disintegration and increase of flexibility through contractual arrangement was the new tactic, applied to financing methods, technologies, customer relationships, labour relationships and corporate governance (Piore & Sabel, 1984; Strauss, 1984; Willman, 1985). The goal of the new industrial policy was flexibility as an end in itself, "a general capacity of enterprises to reorganize in close response to fluctuations in their environment" (Streeck, 1987:290).

The new hybrids were not analysed in their own right, but interpreted as an intermediate step in a general trend towards overcoming the rigidities of hierarchical organizations. The rational choice of contractual forms exposed them to the control of the market. The advantages of contractual arrangements were seen as: (1) the high incentive structure of the market as against the low incentives in a hierarchy; (2) the high adaptability of contractual arrangements in turbulent environments as opposed to bureaucratic closure; (3) a kind of private de-regulation from below which counteracted the rigidities of state regulation. And the normative message for policy-makers and lawyers was clear: Hands off! Do not interfere with the new contractual flexibility! Do not choose the wrong regulatory incentives to drive them back into the old-fashioned forms of hierarchical organizations!

### *1.2. Legal critique: Flexibility is a euphemism for evasion*

Lawyers too were caught by the rigid dichotomy of market versus hierarchy. The character of the hybrid was not really taken seriously. They were pressed into the "Prokroustes' beds of the traditional types of transactions" (Schanze, 1991:68) - either contract or corporation. *Tertium non datur*. Mainstream lawyers treated those hybrids as fully-fledged contracts. A minority of critical lawyers declared them to be de facto organizations.

The prevailing attitude of mainstream lawyers is a deep respect for private autonomy. They accept the express contractual form of hybrid arrangements at face value. They are what they are: contracts (Hager, 1990:110 ff.). Obsessed by the choices of the private parties, mainstream lawyers have blinded themselves to the organizational traits. Hybrids are the blind spot of the doctrinal distinction contract/association. So, faced with the problems that the hybrids throw up, lawyers responses are rather predictable. Can the contractual veil in the construction industry be

pierced? Of course not, for the resulting complexity of a multi-party contractual relation would overburden lawyers' constructive capacities (Hager, 1990:111 f.). What about the organizational liability of a distribution-network? No, this would destroy the established contours of organizational liability (Roth, 1989:437). Labour protection for satellites of a core firm? No, this is *venire contra factum proprium*: You wish *ex ante* to reap the benefits of commercial independence, yet *ex post* claim the protection of labor law (Schanze, 1991:72). And can the protection of the satellite firm be equivalent to the protection of a subsidiary in a group of companies? Certainly, the legislative formulation of § 17 *Aktiengesetz* would be broad enough to cover economic dependency which is not based on equity but on purely contractual links:

> Dependent enterprises are legally autonomous enterprises upon which another enterprise (the dominating enterprise) can exercise directly or indirectly a dominating influence.

But doctrine beats legislation. The dogmatic dichotomy of contract versus corporation is stronger than any broad formulation of statute law. Case law and academic opinion insist, somewhat against the wording of the statute, that the dependence is based on equity (LG Düsseldorf in Zeitschrift für Wirtschaftsrecht (1981) 601 ff.; Sura, 1980:54 ff.; Schmidt, K., 1980:227 ff., 284 f.; Würdinger, 1973: § 17, no. 3; Scholz & Emmerich, 1986: app., no. 45). In spite of the resistance of a minority (Dierdorf, 1978:127 ff.) it soon became the prevailing opinion in group law that § 17 Aktiengesetz cannot be applied to a merely contractual domination of enterprises.

Sometimes, however, the courts themselves got into trouble with the rigid distinction of contract vs. organization. This was the case in the banking sector. Against the the weight of doctrinal opinion, they made the intermediary bank in the money transfer chain directly liable to the customer (cf. Bundesgerichtshof in: Wertpapiermitteilungen - BGH WM 1977, 1042; 1985, 1391). Although the elaborate inter-bank-agreement had explicitly excluded external liability to customers, the courts showed no respect for the banks' private autonomy and authorised the piercing of the contractual veil. But, what began as an equitable exception (§ 826 BGB: *contra bonos mores*) to the rigid market/organization distinction was soon distorted into a phenomenon of 'contorts'. The contract between the customer's bank and the intermediate bank was interpreted as a contract with protective effect for third parties (*Vertrag mit Schutzwirkung für Dritte*).



Even more dramatic was the development of liability in the "grey" capital market. The German courts created "prospect liability" not only for the corporations involved (BGHZ 74, 103, 109), but for their dominant shareholders, managers, initiators and founders (Bundesgerichtshof - BGHZ 79, 337, 340), and even for outside contractual partners of the firm such as legal counsel, finance specialists and accountants (BGHZ 77, 172, 176; in general Assmann, 1985). In fact, the courts made the whole network of "satellites" in a distribution system of capital shares responsible for misleading information. Mainstream doctrine however, successfully isolated this breakthrough as something exceptional, confined to the (pathologies) of the grey capital market (Gernhuber, 1989: § 23 II 6b; Assmann, 1985). And the underlying reason for prospect liability, of course, is not the members' involvement in a highly integrated distribution organization, but the "personal trust" relationship between customers and the individual specialist (BGHZ 79, 337, 341). In both cases, the result is that the location of the blind spot is shifted. The hybrids which deconstruct the whole distinction between contract and organization are domesticated as a well-known problem between contract and tort. "Controrg" is deflected [distorted] into "contort".

It is only critical contract lawyers, who remain a minority, that launch a direct attack on hybrids. They clain that hybrids are strategic instruments of evasion! They point to some empirical evidence which supports the claim that firms use disagggregation strategies in order to evade tort liability (Hansmann & Kraakman, 1991:1881, 1913 ff.) and employment protection laws (Collins, 1990b:360 ff.; cf. also Felstead, 1991:53 f., Schanze, 1991:100; Hirte, 1992:193 f.). What economists euphemistically call "flexibility" turns out, in the sober language of the law, to be an evasion of mandatory rules. The critics blame industrial economists for miscontruing legal evasion as economic flexibility. At the same time they blame mainstream lawyers for their blindness to the economic realities of the hybrids, and for hiding their true nature in a tortured formalism:

> ... the formal recognition of legal identities in complex economic organizations may conceal what in reality constitutes a single set of productive relations which should be treated as a united group for the purpose of the ascription of legal responsibility. (Collins, 1990a:744)

The economic reality is usually a tightly coordinated organization, highly integrated in their information, production, distribution and hierarchical command structure (cf. Martinek, 1987:123 ff., 214 ff.; Dnes, 1991:133

ff.; Felstead, 1991:52). The only reason that the hybrid lacks legal identity is that it has been dismantled into different units of capital connected by contractual links. The result, as Collins calls it, is the "capital boundary problem". This is a split between the multitude of capital units and the unity of organizational decisionmaking:

> ... because the firm determines its own size, it also chooses the limits of its legal responsibilities, which in turn provides an open invitation for the evasion of mandatory duties (Collins, 1990a:737).

It follows that the law cannot tolerate such an evasion of mandatory duties by the mere choice of legal form. The law must treat these arrangement as what they are in "economic reality": fully-fledged organizations to which mandatory rules have to be directly applied.

(1) *Organizational liability*: Since hybrids are integrated functional economic units that perform economic services through an internal division of labor they must also be liability units. This is the reason why in the banking sector, Köndgen (1987:143 ff.) pleads for the full responsibility of the customer bank for the whole transfer process in the money transfer chain (§ 278 BGB). This is a rather extreme reaction when compared to the 'contort' solution of the courts. It treats money transfer nets as an "integrated functional unit" (see also Koller, 1987), centralizes their external liability and maximizes consumer protection at the cost of considerable transaction costs for the banks.

Similarly, franchising nets need to be treated explicitly as fully-fledged corporate arrangements and exposed to the mandatory rules of the law of economic enterprises. Martinek (1987:23 ff.) proposes treating centralized bundles of franchise contracts according to corporate law. He even goes so far as to argue that highly centralized forms of franchising should be subject to the German law of groups on companies (633 ff.). The result would be a far-reaching collective liability. Organizational liability rules would be especially suited to those cases in which franchising committees as quasi-corporate bodies make collective decisions for the whole network (Teubner, 1991:133; for outsourcing cf. Hirte, 1992:197 f.).

(2) *Direct application of labour law protection*: Since hybrids are regarded as evading social regulation it seems to be arbitrary to allow the private choice of organizational form to define the boundaries between an dependent employee and an independent contractor. Even staunch defenders of the hybrid rationality admit that the contractual form "has sometimes been adopted with the explicit intention of evading protective norms under



labor law " (Schanze, 1991:100). From the perspective of critical contract law, Collins forcefully argues that in order to counteract this evasion the

> courts must grasp the bull by the horns and acknowledge that the boundaries must be set ultimately not by reference to the express or implied wishes of the parties but by an act of public policy (Collins 1990b:377).

It is therefore unacceptable that the choice of a hybrid form should deprive de facto employees of core employment rights such as statutory periods of notice, maternity rights, protection against unfair dismissal, redundancy payments, statutory sick-pay, and rights in the case of insolvency and sale of business (355). The one right answer is a "mandatory imposition of these rights by reference to social and economic criteria which reduce as far as possible the influence of the employer's choice of form" (380). These criteria are formulated along a dual axis of employment made up of, on the one hand, variations in risk allocation and, on the other, in bureaucratic control. This distinguishes between the "market" of independent contracting and the "organization" of employment where labour protection is granted notwithstanding the parties' choice of the legal form of contract or corporate arrangement.

(3) *Subsidiary protection and co-determination in "just-in time" delivery contracts*: Nagel, Riess & Theis, 1989, 1990, develop a similar argument for just-in-time-networks in their relation to the law of corporate groups. They avoid the formalistic distinction between contract or capital equity as the basis for an economic dependency relation which is responsible for group formation. Instead, they refer directly to structural peculiarities of just-in-time networks which they call "systemic compulsion" (*Systemzwang*).

> The essential characteristic of the new production and logistics stategy is a holistic concept of the entire production in a "logistic chain" which comprises all phases from consumer to producer to deliverer. ...The compliance of the deliverer probably owes as much to logistic systemic compulsion as it does to equity-based influence (Nagel, Riess & Theis, 1989:1505, 1511).

This systemic compulsion transforms the nexus of just-in-time delivery contracts into a de facto corporate group. Thus, they argue that the core firm owes a fiduciary duty to the business interests of its satellites and is liable for damages if it violates this duty. Moreover, the mandatory rules on workers' participation in corporate groups would then be directly applicable to just-in-time networks. Since just-in-time contracts are them-

selves de facto corporate groups the employees of the satellite firms would have the right to send their representatives into the works council and into the supervisory board of the core firm (- § 54 Betriebsverfassungsgesetz, § 5 Mitbestimmungsgesetz, § 18 Aktiengesetz.)

## 2. Economic argument § 2

### *2.1. The argument: Not evasive behaviour but transaction cost savings make hybrids efficient*

After this first round of economic argument and legal critique, economists have to rethink. If lawyers have revealed that in legal terms economic flexibility means an evasion of mandatory rules, economists need to change their argument in order to defend the rationale of hybrids. They may criticize existing regulations as inefficient and attack them directly by means of public choice concepts. But as loyal citizens of a democratic polity they can no longer recommend economic actors to circumvent democratically legitimate regulations by an underground-strategy of contractual "flexibility". Moreover, if the law is not as formalistic as economists tend to expect and if the courts actually pierce the contractual veil in order to counteract evasion, economists need to transform the prized veil into an iron shield that will defend the new contractual arrangements in their own right. This is exactly what is happening in the famous transaction costs revolution.

The transaction cost approach has been instrumentalized as a political weapon from its very beginning. At least since the appearance of "Markets and Hierarchies" (Williamson, 1975), economists have successfully used transaction costs arguments to attack the arguments of interventionist lawyers and policy-makers. The trick is to introduce a new distinction - evasion versus efficiency. The obsession of lawyers and policy makers with evasive behaviour is ridiculed. They are accused of paranoia because whenever they see inventive contractual arrangements they compulsively think that opportunistic actors are disguising hierarchical organizations under a new contractual regime in order to monopolize markets, to evade anti-trust laws or to circumvent other social regulations. This, they claim, is a fiction dreamed up by lawyers and that in economic reality rational economic actors are choosing contractual arrangements exclusively in order to economize transaction costs. Rational actors calculate the comparative transaction costs of alternative institutions: short-term contracting, long-term



contracting, loosely coordinated organizations, hierarchical unitary organizations, corporate groups. Their choice is dictated exclusively by the new categorical imperative: Minimize transaction costs (Williamson, 1985: passim). They choose hybrids only when they offer relative advantages in the comparative costs of planning, screening, contracting, monitoring and enforcing. "Suitable legal regimes which would make transactions, their planning and their enforcement less costly thus become, from the efficiency point of view the subjects of an optimization analysis" (Schanze, 1991:89).

### *2.2. Legal critique: Distinguish legitimate and illegitimate transaction cost savings*

This argument gives an almost deadly blow to the evasion argument as the recent fate of anti-trust law shows. Under the attack of economic arguments, especially the transaction costs approach, anti-trust policies against vertical restraints on trading are withering away (cf. Joerges, 1991:52 ff.). Any suspicion of illicit monopolizing motives has been replaced by the praise of the "positive welfare effects of regimes that economize on the transaction costs of atomistic trading" (Schanze, 1991:89). How can lawyers resist, especially if they are now told that the positive and normative function of private law is economic efficiency and minimization of transaction costs. How can they resist if in other areas of contract law they are told that "efficient breach of contract" makes legal sense. The message is: You are entitled to break your contractual promise whenever it is efficient, i.e. when the costs of damages are lower than the costs of performance. How can they resist when in regulatory contexts they are told about "efficient regulation" and "optimal sanctions". There the message is: You are not only entitled, even more, you are under the legal (!) obligation to violate a state regulation "when violations are profitable to the firm", i.e. if the costs of the sanctions are lower than the costs of compliance (Easterbrook & Fischel, 1982:1168 note 36, 1177 note 57; 1985:614 ff.).

Everything depends on the legal critique of economic reason. Does, indeed, efficiency define legality (see Posner, 1987)? Or is there an epistemic autonomy to the legal discourse (Luhmann, 1987)? Does law construct an independent conceptual apparatus which could critically examine claims to economic efficiency according to criteria of legal policy and legal doctrine? The crucial point is neither wholly to accept nor reject these claims but to undercut them by a new distinction within the law: legitimate versus illegitimate transaction cost savings.

There is no built-in limit of legitimacy in transaction cost economics. On the contrary, the transaction cost approach explicitly builds on a highly realistic anthropology. Opportunism is seeking self-interest with guile! (Williamson, 1981:1545;1985; cf. also Lindenberg & Vos, 1985:562 ff.; for a critique, see Gordon, 1985:568 ff.). Efficiency gains are neither good nor bad. Morally, politically and legally they are just neutral. Therefore it needs "second order observation" (von Förster, 1981; Luhmann, 1984) of efficiency gains. This would judge them from a point of view of legal policy. This second order observation operates, as we saw above, with a three-dimensional optics (Teubner, 1992: ch. 6). First, every transaction cost saving needs to be subsumed under the *binary code of law*: is it legal or illegal? Second, efficiency gains need to be questioned as to whether they are compatible with *legal programmes*, i.e. the political goals of democratic legislation translated into legal "policies." Third, the economic principle of efficiency cannot in itself determine legality. Rather, it is the other way around. Justice has to control economic efficiency. Old-fashioned "justice", the *formula of legal self-reflection* still has a decisive role to play in modern legal systems, in spite of Kelsen's verdict (Kelsen, 1960:355 ff.). Under modern conditions justice can no longer be understood as a *justitia mediatrix* in the Aristotelian sense. But justice can be reformulated as a legal balancing of the internal consistency of law against different rationalities in society, including political, everyday and ecological communication (for such a re-interpretation of justice Teubner, 1992: ch. 6; 1993a; cf. as well Frey, 1989:97 ff.; Preuß, 1989:551; Wiethölter, 1989:509 f.; Ladeur, 1992:169; Blecher, 1991:215 ff.).

Our hybrids cannot then be uncritically accepted as "efficient" in the legal discourse. Transaction cost savings need to be exposed to legal scrutiny, item by item. Are the specific cost savings legitimate or illegitimate? Savings in contract planning, screening, contracting, monitoring will easily pass the legitimacy test. Savings in enforcing them may already be a problem. Not every "hostage taking" that saves enforcement costs can be accepted by the law, not to mention other forceful and highly "efficient" private means of law enforcement. Candidates for legal scrutiny would be choices of organizational forms that save costs by limiting liability, such as by splitting up franchise organizations into a multitude of contracts which dissolve corporate into individual liability (cf. Teubner, 1991:107 f.). Likewise the legitimacy of contractual arrangements that shift internal risks to third parties (Collins, 1990a:774). And the savings of labour costs (Felstead, 1991:53) need to be re-examined from the standpoint of labour law policy (Collins, 1990b:377).



If legal doctrine distinguishes systematically between legitimate and illegitimate transaction cost savings it might succeed in defining a selective legal policy towards networks, a policy that copes with what sociological observers of networks call their "double edge". This policy would not destroy, but facilitate the "move toward relational contracting, with greater emphasis on security and quality". On the other hand, it would make illegal those tendencies of the networks that fostered "a return to earlier times, a part of a campaign to slash labour costs, reduce employment levels, and limit the power of unions even further" (Powell, 1990:321).

Thus, the law is supposed to function as a filtering mechanism in the "natural" evolution of efficient organizational patterns. If the law succeeds in the effective prohibition of certain cost savings it will filter out illegitimate efficiency gains and, thus, re-direct the development of industrial organization. From such a perspective, transaction costs economics cannot be *in toto* be incorporated in the law as some law and economics scholars would have it. Law would incorporate transaction cost economics by critically reconstructing it within the autonomous apparatus of legal concepts, norms, policies and principles of justice. More practically, this would mean that hybrids whose efficiency gains are based on legally illegitimate transaction cost savings would disappear to the extent that the law was enforced. The guiding principle must be that law keeps the level of social regulation constant over the whole range of governance structures - contracts, hybrids, organizations. It is only under this limiting condition that transaction cost economies would drive economic evolution toward (legitimately) efficient hybrid arrangements.

## 3. Economic argument § 3

### *3.1. The argument: Hybrids are a third order "between" contract and organization*

Of course, this principle runs contrary to economic intuition, according to which the free development of hybrids should not be hampered by legal regulation. "Uncritical application of consumer protection and minority protection rules to situations of voluntary symbiosis, may however, kill many hens with golden eggs with small benefits conferred to the individual claimant." (Schanze, 1991:98). At the same time, the principle of keeping social regulation constant is perfectly in tune with the equalizing tendencies of a comparative institutional approach in transaction cost economics (Williamson, 1985; 1991).

An economic solution to this dilemma is to stress the uniqueness of the hybrids, to admire the miraculous idiosyncrasies of the geese with the golden eggs! Indeed, the most sophisticated argument in law and economics to date is that hybrids are a third economic order "between" contract and organization. It is argued that they are "discrete structures", "generic forms" which are distinguished from contract and organization by different coordination and control mechanisms (Williamson, 1991:269, 280 f.). The specificity of "symbiotic contracts" is that one partner totally transfers control to the other, but retains the ownerhsip and residual income. Symbiotic contracts have an incentive structure (asymmetry of agency) and a risk structure (sunk investments) of their own. This in principle excludes the application of social regulation which has been developed for contract or organization (Schanze, 1991:95 ff.).

In a peculiar way, this argument runs against a deeply rooted tradition of economic thought that has tended to flatten the differences between contract and organization. It runs against the spirit of recent economic "theories of the firm" which reject notions of hierarchy, corporate actor, boundaries of the firm as "traps", "errors" and "fictions", and insist that firms are nothing but contracts. In the firm as a nexus of contracts individual resource holders are involved in a daily process of re-negotiating the contractual terms (Jensen & Meckling, 1976:311; Easterbrook, 1989). There are no relevant differences between contract and organization, since organizations are just a subclass of contractual arrangements through which the payment flows pass smoothly (Grossman & Hart, 1986). According to the neoclassical version, organizations do not differ "in the slightest degree from ordinary market contracting between two people" (Alchian & Demsetz, 1972:777).

This third order argument also runs against the more moderate institutionalist version. According to this, contracts, hybrids and organizations are different institutions, though made of made of the same stuff - economic transactions. They differ only in the governance structures which are essentially designed to control opportunistic behaviour (Williamson, 1985; 1988). Hybrid arrangements are not a third order, but just one point on this sliding scale where, on the one hand, market controls are weak because of the asset specificity of the transaction, and on the other the transaction costs of fully integrated organization are too high. Although transaction cost economics has recently tended to oscillate somewhat between a continuum model and a discrete structure model, it has nonetheless retained the idea of an intermediate structure "between" contract and organization (Williamson, 1991: passim).



Thus, in order to defend the hybrid logic against political-legal interventions, economic analysis of law finds itself in a somewhat paradoxical position. Economic analysis is compelled to resort to non-economic constructs. Hard-nosed economists borrow from collectivist legal historians (Gierke, 1914:410 ff.), communitarian legal theorists (Macneil, 1980) and structuralist sociologists of organization (Powell, 1990) who have analysed "relational" networks as institutions in their own right and have insisted on their fundamental differences from contract and organization. The hybrid fusion of economics with sociology culminates in the statement: "Legal symbioses cannot be adequately explained within the logic of exchange or of corporate hierarchy" (Schanze, 1991:103). It sounds as if we have reached the peak of a socio-economic synthesis.

However, when it comes to the practical legal question of how such symbiotic contracts can be "constitutionalized" (96), and to the concrete policy question of what kind of "independent criteria must be developed for the internal and external law of this category" (98), then in a strange loop we are suddenly back where we started. [This is clear when we turn to the proposed solutions for our problem areas.]

There is first the question of the external liability of "symbiotic contracts". Here it is argued that due to their unique characteristics, a legal liability deduced from the unity of the network is "simply not needed" (98. Fn. 130). Then labour protection for the dependent entrepreneur is denied for "A paternalistic extension of labor law policies, designed for the context of classical industrial organization, would suppress productive specialization of a new kind" (101). It goes without saying that the contractual protection by the German Unfair Contract Terms Act is also excluded. Why? It is the very specificity of symbiotic contracts that they are "marked by mutually agreed (!) asymmetries" (96). And, there can be no analogy to the law of parent and subsidiary corporations. In symbiotic contracts, there are "no problems" of the internal protection of minorities, since "the division of competence is present from the beginning in full acceptance (!) of the possible dependency" (98). Externalities of private arrangements, different bargaining positions, asymmetric organizational power present no problem! It seems as if the idiosyncratic third order of symbiotic contracts is exempt from one hundred years of private law history.

Now we understand the hidden reason why the logic of exchange and the logic of hierarchy cannot be applied to symbiotic contracts. The whole conceptual manoeuvre to justify the unique character of the third order by rendering them incomparable to contract or organization seems to have been made in order to effectively block the analogy with traditional legal

forms of regulation. There is only one moment where the overriding concerns of "efficiency considerations" have to give way - when "the tenets of human dignity (!) are at stake" (99). The circle is closed. The most recent "third order concept" of hybrid institutions turns out to be a grand political justification for the new social movement of private de-regulation.

### 3.2. *Legal critique: Hybrids do indeed produce synergies "beyond" contract and organization, and particularly synergies of risks for other people*

A legal critique of economic reason would have to take the "third order" argument really seriously, but would have to radicalize it. No doubt, the clear-cut distinction between market and hierarchies is simply inadequate to deal with hybrids (Imai & Itami, 1984; Astley & Fombrun, 1987:167 ff.; Jarillo, 1988; Powell, 1990). It makes no sense to fight over the question of whether hybrids have to be classified as either contracts or organizations and to draw legal conclusions from this. Both positions are right and wrong at the same time. Hybrids place their members in a truly "paradoxical position" with regard to control, finance and ownership (Felstead, 1991:38). The reason is that by developing hybrids, socio-economic practice has itself deconstructed the comfortable market/hierarchy distinction. This has far-reaching consequences. The new realities of hybrids,

> "... a social world of semi-autonomous contracting cultures, governed by relations of cooperative organic solidarity and of pervasive hierarchical domination, is deeply upsetting to the core premises of our liberal social order" (Gordon, 1985:575).

And we cannot see the third order fully if we look exclusively through the lens of economics. It is simply not sufficient to look only to the idiosyncrasies of incentive structure and risk distribution. Transaction theory is perfectly right in stressing asset specificity and agency theory is perfectly right in stressing the principal agent asymmetries. But they still miss the radical innovation of hybrids - their character as *polycorporate actors*.

Only attribution theory, I submit, can sensitize us to this peculiarity of hybrids. Attribution theory denies that the quality of action is a "natural" attribute of individual human beings (e.g. Kelley, 1967). Action is not inherent only in "natural persons". Gods, oracles, corporations, and individuals all have, in principle, the same right to act. For attribution theory,



the attribution of events to acting units is contingent. It is - as Foucault (1974:xxiii) could tell us - a matter of historical and social variation. Animism is one, collectivism another, individualism a third variation of the same theme. Action is not an ontological or natural privilege of individual actors. A complex social mechanism called attribution decides about the construction of "persons" as action units and the imputation of communicative events to these social constructs called "persons". The "legal person" is one of the greatest cultural achievements of the legal discourse, and has enormously facilitated the creation of new social realities out of communicative fictions (for details, Teubner, 1988a).

Of course, economists will not follow the law in this respect. They will not listen to attribution theory. Their pledged allegiance to methodological individualism forbids them to acknowledge the economic reality of corporate actors and requires that they be dissolved into a nexus of individual contracts.

> The attempts of the new institutional economics to analyze organizational behavior solely in terms of agency, asymmetric information, transaction costs, opportunism and other concepts drawn from neo-classical economics ignore key organizational mechanisms like authority, identification, and coordination, and hence are seriously incomplete (Simon, 1991:43).

What economic theory cannot see is that corporate actors do constitute preferences of their own which cannot be reduced to individual preferences or to their aggregation. Corporate actors produce their own constraints by constructing an organizational image of the outside world. Corporate actors make collective choices that have emergent properties in relation to individual choices. Corporate actors have rights and duties that go beyond the lifespan of any individual member. They are the principals and not the shareholders of the principal-agent relation, as agency theory would have it (Luhmann, 1984:270 ff.; Teubner, 1988a:130 ff.; 1988b:66 ff.; Knyphausen, 1988:120 ff.; Hutter, 1989:90 ff.; Ladeur, 1989; 1992:186 ff.; Robb, 1989; Vardaro, 1990). But of course, as economic theory repeatedly tells us, these are just "traps", "errors" and "fictions".

Even more so when it comes to hybrids. The decisive innovation of hybrids is, I submit, a strange double attribution of action: One and the same event is simultaneously attributed to a natural person and to a corporate actor (see Teubner, 1991). In contract and organization we have simple attribution. In a contract, even in a long-term cooperative relational contract, actions are attributed, of course, to one of the parties to the contract, never to the contract as such. A personified contract is, of course, some-

thing that is completely unheard of in legal theory (with one exception: 1801 in the Grafschaft Castell, Germany, the marriage relation was legally declared to be a legal person, Ebel, 1978:638). In a corporate arrangement, action is legally attributed to the "legal person" represented by the actions of natural persons, the "organs" of the corporate body. Networks break with this dichotomy. A "network operation" emerges as a new elementary act from the twofold social attribution of actions. Every communicative event in the network is simultaneously attributed both to one of the autonomous parties to the contract and the organization as a whole. The dual constitution of elementary acts is repeated in the "network structure". Every hybrid operation must simultaneously meet the normative requirements of both the contract between the individual actors and the corporate actor, which is the network organization as a whole. In this non-metaphorical sense, hybrids are polycorporate actors.

The result of this is a remarkable self-regulation of the network, based on a twofold orientation of action (Scharpf, 1991:22). We find here the explanation for "profit sharing" between the network and the nodes. In economic terms, all transactions are oriented both towards the network's profit and to the profit of the individual actor. This double orientation works as a "constraint", since all transactions must pass the double test. At the same time it works as an "incentive", since network advantages are bound up with individual advantages. Through cunningly devised incentives and penalties, individual contractual clauses seek to ensure that the double orientation actually affects the actors' motives (Dnes, 1988; 1991). The economic nub of franchising by comparison with, say, distributive networks in an integrated firm, even with internal incentive programmes, lies in the "residual claim" for the franchisee (for a particularly clear, empirically based study see Norton, 1988). Due to savings on "monitoring costs", the "residual claim" is regularly higher than comparable "incentives" in distribution networks of integrated firms (see Rubin, 1978; Brickley & Dark, 1987:411 ff.; Dnes, 1991). Economists analyse this twofold orientation in terms of "principal-agent incentives" and "information incentives" (Norton, 1988: 202 ff.; see also Klein & Saft, 1985; Mathewson & Winter, 1985).

From this perspective we can discover novel aspects in various existing theories which have stressed different aspects of the hybrids make-up.

Macneil (1980), for instance, would claim that hybrids are relational contracts. He would stress the aspects of duration, complexity, social embeddedness and cooperation. This is true but it must be added that in some cases of especially dense cooperation, the relational contract itself becomes personified as a corporate actor which binds individual action by the corporate actor's interest, preferences, constraints, world constructions, rights and duties, without at the same time dissolving the actor qualities of the parties to the contract.



Schanze (1991) defines symbiotic contracts, as we have already noted, by the combination of the total transfer of control in a principal-agent relationship with the retention of ownership and residual income (similarly Hadfield, 1990:991; Felstead, 1991:38). Indeed, - but to whom is control transferred? To the central manager, to the core firm or to the network itself? Legally, at least, it makes a big difference whom we declare as the principal. This decides the legal scope of fiduciary duties, and of the "corporate interest". In our view the principal is not an individual actor, but a legal fiction. The "network" itself is the principal in relation to which the satellites as well as the core firm are agents.

Williamson (1991:278 f.) sees hybrids as combining two responses to outside disturbances: the "autonomy" reaction of independently calculating individuals, and the "cooperation" reaction of the organizational "fiat". Hybrids display "semi-strong adaptations of both kinds" (281). This makes them especially vulnerable to frequent outside disturbances, such that "the hybrid mode could well become nonviable when the frequency of disturbances reaches high levels." (291). So far so good. But if one takes double attribution into account, the opposite result seems more plausible. Double attribution gives hybrids a synergetic advantage in their adaption to disturbances which makes them superior to either contract or organization. The reason for this is that the proportion of the blend of market and organization is not fixed. It can vary according to strategic viewpoints. In the case of outside disturbances, network management can choose - and can change this choice over time - whether the hybrid reacts as a whole or whether the nodes react autonomously. By contrast to both contract and organization, that dispose about one stabilizing mechanisms, this pattern characterizes the network as a "multi-stable system" (Pausenberger, 1975:2243).

Collins (1990a:737). sees a "capital boundary problem" at work, that is the divergence between an organized action unit and a multiplicity of capital units. This is indeed the central problem of hybrids. We need not, however, regard this only as an evasion strategy concealing the reality of a centralized organization. Instead, it becomes possible to understand hybrids in their own logic without, however, loosening the regulatory grip.

Macaulay (1991) discovers quasi-political aspects in private contracts. He defines hybrids as "private governments" with hierachy and domination. Attribution theory would add an element of "politicization". Some

hybrids develop a quasi-state, a political action centre of power and control.

Both Collins and Macaulay open our eyes to the "dark side" of the hybrids (Gordon, 1985:570). There is a whole literature on networks that analyses in detail the benign aspects of hybrid arrangements: their flexibility, their efficient market controls, their low transaction costs, their effective monitoring, the checking of the opportunistic behaviour of the satellites, their innovative behaviour, their synergies (cf. MacMillan & Farmer, 1979: 277; Kaneko & Imai, 1987; Jarillo, 1988; Lorenzoni, 1989; Powell, 1990). All this is due to their sophisticated combination of contractual and organizational elements. But apart from a few scholars (Collins, 1990a; 1990b; Felstead, 1991; Joerges, 1991; Macaulay, 1991; Sciarra, 1991) nobody talks about the internal power relations, the exploitation of the internal members opportunistic behaviour by the core firm itself, the collectivization of action without concomitant collective responsibilities, the shifts of risk to third parties, the artificial contractual restrictions of responsibility and the synergies of risks for other people. This dirty work seems to be left to the lawyers who get surprisingly little help from legal economists.

We can briefly give an example of how hybrids create synergies of risks for other people. Empirical research in product safety suggests that in highly decentralized organizations which delegate decision-making power to profit centres and satellite firms there emerge "especially subtle hazards caused by the interaction of subsystems in a technologically complex product". These researchers blame the high division of labour and the highly decentralized controls which we typically find in hybrids for the risks that arise for "...there is a temptation to believe that the product as a whole is safe if each subsystem is safe" (Eads & Reuter, 1983:95). Thus, the very character of the network with all its efficiencies creates external risks due to a lack of coordination among the profit centers.

Exactly the same problem arises with ecological problems. Loosely coordinated networks of economic actors are one of the contexts in which the problem of multiple causation is recognised. Sometimes the detrimental effects to the environment are the synergetic result of the diverse actions of different nodes.

In both cases, contrary to the stern verdict of legal economics according to which a structural liability deduced from the unity of the network is "simply not needed" (Schanze, 1991:98, Fn. 130) the need to introduce a collective liability seems obvious. In the product safety case it needs an "organizational duty" on the part of the network centre to coordinate the complex interactions of the subsystems in order to avoid those subtle



hazards. The question of how we doctrinally qualify this duty - as tortious, contractual, contortious or quasi-corporate - is secondary. In the ecological case, law needs to replace individual causal attribution by a collective contribution in order to cope with synergetic hazards (see Teubner, 1993b). Again, the question of how the collective is to be legally classified is secondary. It can be as a community of tort-feasors with joint and several liability or a compulsory risk pool - the famous "bubble" of industrial air polluters - defined by the force of law. Overall liability is collective and individual contributions are re-allocated internally.

## 4. Controrg - The emerging law of organized contracts

It is clear that such a view of hybrids needs an adequate legal specification in legal doctrine. But such a law of organized contracts would not just be built on thin air. It can attempt to synthesize three traditional doctrinal concepts and combine their legal consequences: long-term contracts (*Dauerschuldverhältnisse*), linked contracts (*Vertragsverbindungen*), and mixed arrangements (*gesellschaftsähnliche Vertragsverhältnisse*). The concept of long-term contract stresses somewhat one-sidedly the temporal dimension. Hybrids are characterized by their long duration and their intensity. The most important legal consequences are the imposition of intensive fiduciary duties and a legal regulation of undue termination of contract (Gernhuber, 1989: §§ 16 f.). Linked contracts, by contrast, focus on the social dimension. They thematize the multiplicity of actors, who are not connected via corporate arrangements. The legal consequence is the abandonment, partially or wholly, of the privacy principle and the imposition - independently of the parties' express wishes - of a legal bond between these contracts. This may be done by constructive interpretation, the rules of basis of contract (*Geschäftsgrundlage*), or the more audacious *actio directa* and *exceptio directa* (Gernhuber, 1989: § 31 I) Recently, there has been a renewed doctrinal interest in linked contracts under the name of network contracts (Möschel, 1986; Adams & Brownsword, 1990:25 ff.; Teubner, 1991). Finally, mixed arrangements focus on the substantive dimension. What is the relational substance of the arrangement? Is its legal purpose exchange or cooperation? Or both? (see Wolf, M., in: Soergel, 1986:§ 305, No. 22). The legal consequences are rules for an internal constitution of the hybrid: division of labour, representation of the rudimentary corporate actor, distribution of gains and losses. And, just as important this would be *sedes materiae* for rules on individual and collective liability.

These three concepts could form the nucleus for developing a full-fledged doctrine of "controrg" (Sean Smith), a law of contractual organization. They would treat hybrid forms as "third order" beyond contract and organization which need peculiar "network"-adequate protective norms. If their specificity lies in the unity of an organization with decentralized action units then the guiding principles in our three areas of interest would be the following:

*External liability of networks*:

External protection should be provided by the law not, however, according to the unified collective liability of corporation law but as a combined, decentralized, and multiple liability of the network and the concretely involved nodes. As compared with the liability of "real" formal organizations this would reflect the relative re-individualization of collective liability. Increased synergy risks in networks would have to be compensated for by the increased liability of the network. In these cases, due to the increased risks, the level of protection to outside creditors would exceed the level of protection in contract and in organization (for some details, Teubner, 1991).

*Minority protection for members in the network*:

Internal protection should be provided by the law, again not according to the dependency model of labour law but to the "semi-autonomy" of decentralized action centres. New protective rules are needed that would safeguard their autonomy, status and reciprocity (for some details, Joerges, 1991:21 ff.; Joseph, 1991:473 ff.; Sciarra, 1991:258 ff.).

*Collective interest representation in networks*:

Collective interest representation should be provided by the law. Again this should not be according to the unified collective representation of corporation and co-determination law in rigid institutions but in a countervailing power centre that does not lay down a rigid catalogue of competencies but possesses the legal equipment of flexible contractual arrangements for legitimation and control (see Teubner, 1992: ch. 8).

In conclusion we can refer to some speculations on the contemporary meaning of the term organized capitalism, for these suggest deeper structrual reasons for the growth of the phenomenon that we have been discussing.



> An economy composed of many firms making many products which compete in many markets is qualitatively different from the economy of classical microeconomic theory or from theories of monopoly and oligopoly which focus on single markets. Today's economy is built on transaction between profit centers which are embedded in firms, not upon transactions between single-product firms. (Eccles & White, 1986:211; similarly Mayntz, 1992: 19)

If this is so then it might be plausible to argue that the law of "controrg" will perhaps become relatively more important than the law of contract or the law of corporations.

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